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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1956

No. 312

E. J. MURRAY,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Ninth Circuit.

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Petitioner respectfully prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit entered in the above-entitled case on March 30, 1956.

OPINIONS BELOW.

The opinion of the Tax Court (R 51-77) of the United States is reported at 21 TC 1049. The opinion of the United States Court of Appeals for the Ninth

Circuit, printed in Appendix B hereto, *infra*, is reported at 232 F. (2d) 742.

JURISDICTION OF THIS COURT.

The jurisdiction of this Court is founded upon Section 1254 (1) of Title 28, U. S. Code. The judgment of the United States Court of Appeals for the Ninth Circuit was made and entered on March 30, 1956 (Appendix B, *infra*). Thereafter, a timely petition for rehearing was filed but was denied by an order entered on May 15, 1956 (Appendix B, *infra*).

QUESTION PRESENTED.

(1) Where a lien against a taxpayer's real property does not constitute his personal obligation or liability, does he realize ordinary income in the amount of net rentals credited to him in a final accounting of his suit to recover title and possession of his property?

(2) If above question be answered in the affirmative, then is the income all taxable to him in the year in which the accounting proceeding was terminated, or in each year when actually collected for the account of the taxpayer by the mortgagees in possession?

STATUTE INVOLVED.

The applicable statute is Section 22(a) of the Internal Revenue Code of 1939 (26 U.S.C. 1952 Ed.

Sec. 22, now Section 61 of the Internal Revenue Code of 1954), set out in Appendix A, *infra*.

STATEMENT OF THE CASE.

In 1928 petitioner executed a first mortgage on his property in Klamath Falls, Oregon, to secure a loan of $64,000 (R 32). In 1932 when the mortgage was in default and there was due and owing a balance of $57,000, the petitioner conveyed the property to Conger Corporation, the alter ego of the attorneys to whom he was indebted (R 33). In 1935 the first mortgagee foreclosed and bought in the property for the unpaid debt (R 33). In 1936 the Conger Corporation gave notice of its intention to redeem (R 34). It then assigned the right of redemption and delivered a deed to the Watters Group which redeemed the property, entered into possession and claimed to be the owners in fee, free from any claim of petitioner (R 34).

In 1938 petitioner sued to establish his ownership to the property and require an accounting (R 35). In 1942 the Supreme Court of Oregon (169 Or. 381, 127 P. (2d) 112) reversed a dismissal of the case by the trial Court and held that the Watters Group were mortgagees in possession, that petitioner was the beneficial owner of the property and that upon payment of the amounts of the liens of the defendants he was entitled to a reconveyance of the property (R 36-39). On remand of the case for a full accounting, the trial Court determined that there was

a balance due on the accounting of rents and profits in favor of defendants and entered judgment against petitioner (R 39-40). On appeal by both parties the Oregon Supreme Court in 1947 sustained the lower Court's accounting conclusions, but modified the decree to provide that defendants should have a lien upon the mortgaged property in the amount of the ascertained balance, and eliminated the personal judgment against petitioner (R 40-41).

The final accounting showed a balance in favor of the Watters Group for the over-all period from March 23, 1936 to February 28, 1947, of $10,640.31. On this latter date, petitioner paid this amount and entered into possession of the property pursuant to a final decree of the trial Court (R 42).

Petitioner, a cash basis taxpayer, filed no income tax returns for any of the years 1937 through 1945 (R 46). He had no income during those years, but in July of 1947 he filed separate returns for all the years 1937 to 1946, reconstructing the income he would have had in those years had he been in possession (R 46).

On August 13, 1951, the Commissioner determined a deficiency in petitioner's income tax for the year 1947 based for the main part on the theory that as a result of the lawsuit petitioner had realized ordinary income of $57,512.64 for that year. This sum was arrived at as follows: Gross rents from the property for the entire period were $102,589.45. To this was added interest of $33,218.74 resulting in total gross receipts of $135,808.19. Against these credits peti-

tioner was charged with maintenance expenses of $25,501.01, and interest on the mortgage and other disbursements totaling $78,295.55. The balance of $57,512.64 was charged to petitioner as ordinary income (R 14-21).

Thereafter, petitioner filed a petition in the Tax Court of the United States to review respondent's decision (R 6-13). The Tax Court redetermined the deficiency for the year 1947 at $32,332.37, but sustained the respondent's ruling that petitioner realized $57,512.64 ordinary income in 1947 from the termination of his lawsuit (21 TC 1049) (R 79).

Thereafter, a petition to review the decision of the Tax Court was filed with the United States Court of Appeals for the Ninth Circuit, pursuant to Section 7482 of the Internal Revenue Code of 1954 (R 80-85). The Court of Appeals affirmed the judgment of the Tax Court (R 94-102). Only two judges participated in the decision. By reason of facts which came to his attention after the submission of the case, Judge Stephens deemed himself disqualified and took no part in the Court's decision (R 102).

REASONS FOR GRANTING THE WRIT.

It has always been a well-settled principle of income tax law that the reduction, satisfaction or cancellation of a mortgage, indebtedness assessment or real property lien which is not a personal obligation of the owner does not result in taxable income to him. At most, it can result in some adjustment in

the basis of the property (see cases collected in 2 *Mertens, Law of Federal Income Taxation (1955 Revision)* § 11.19, pp. 60-61).

The credits which petitioner received in the final accounting on his suit to recover title and possession of his property and which were applied to reduce the defendant's judicially-created lien on the property did not arise out of any personal obligation owed by petitioner to the accounting defendants. Under similar facts as in the case at bar, the United States Court of Appeals for the Fifth Circuit in *Hilpert v. Commissioner of Internal Revenue,* 151 F. (2d) 929 (CA 5) determined that such net rentals applied in favor of a taxpayer upon a real property redemption did not constitute ordinary income (Appendix C).

Because of the direct conflict between this decision of the Court of Appeals for the Fifth Circuit and the opinion of the Court below, this Court should grant the petition for a writ of certiorari in order to resolve a question which frequently arises in the administration of the income tax laws.

While recognizing petitioner's reliance upon the *Hilpert* case, the Court below refused to acknowledge that the *Hilpert* case was directly applicable. The Court stated "that there is nothing in the *Hilpert* case which calls for a contrary conclusion." It outlined the facts of the *Hilpert* case in footnote 2 of its opinion as follows:

> "There Hilpert had given one Markell a deed absolute in form conveying rental property in Florida. In his tax return for that year (1931)

Hilpert, following a ruling of the Collector, reported this as a sale for the amount he received, $65,000, and paid income taxes on a capital gain of $49,209.69. As a result of an action by Hilpert against Markell, the Florida courts held the transaction to be a mortgage instead of a sale, and held that Hilpert could redeem after an accounting of the rents. Hilpert made an arrangement with Lawton Investment Co., whereby he executed a deed to the latter placing it in escrow with an arrangement that if his suit to redeem was successful, the Lawton Investment Co. should have the right to redeem and acquire the property, in which case Hilpert was to receive $10,000 from Lawton plus half the difference between $65,000, the amount which the deed was given to secure, and any less sum which the court should decree as the amount required to be paid, to redeem. After successful termination of the suit in 1940, Lawton redeemed the property and paid Hilpert $10,000 plus half the difference between $54,364.67, the amount fixed by decree as the redemption sum, and $65,000, together with some commissions agreed upon. Hilpert thus received $17,067.67, which he returned as his income from the transaction.

(The sum of $54,364.67 decreed to be the redemption sum, was arrived at by crediting against the $65,000 mortgage paid, the sum of $10,645.33 of net rentals which Markell had collected.)

The effort of the Commissioner then to charge Hilpert with a capital gain measured by the difference between the sum of $54,364.67 and $10,635.33 and the basis, or March, 1913, value of the property, was properly overturned. The rent-

> als there aggregated only the $10,635.33. Thi
> was less than the amount Hilpert reported. Th
> $17,067.67 was all he could possibly be said t
> have received. It is hard to imagine by wha
> reasoning the Commissioner arrived at th
> claimed deficiency. The decision of the court o
> appeals was plainly correct, but we find nothin
> there which aids petitioner here."

The Court's observation that the ". . . effort o the Commissioner then to charge Hilpert with a cap ital gain measured by the difference between the sur of $54,364.67 and $10,635.33 and the basis, or March 1913, value of the property, was properly overturned is a serious misstatement of the *Hilpert* case. Thi prompted the Court to find that the *Hilpert* case di not involve the identical issue presented here, to wi whether or not petitioner realized ordinary incom attributable to net accumulated rentals credited t him in the accounting.

In the decision of the Tax Court in the *Hilper* case (4 TC 475) appears the following finding:

> " 'In the deficiency notice respondent determine "that the amount of $10,635.53, representing ne rentals received by the mortgagee on Lot 4, Bloc 29, Reid's Addition to Orlando, Florida, and ap plied as a credit on your mortgage during the tax able year, constitutes ordinary income." He als computed gain from the sale of the property a $55,764.12 by deducting from a "sale price" o $71,432.37 an adjusted basis of $15,668.25.' "

The Tax Court (4 TC at p. 477) stated with referenc to the credit attributable to accumulated rentals:

> " 'This item is additional to and not in substitution of any part of the capital gain already dealt with . . . We conclude that petitioners' tax should be computed on $55,764.12 as long term capital gain and on $10,645.33 as ordinary income.' "

The opinion of the Court of Appeals for the Fifth Circuit reversed in its entirety both portions of the deficiency entered by the Tax Court and was a direct holding that net rentals credited to the Hilperts on a final accounting in their suit to recover possession of real property could not be taxed as ordinary income in the absence of any personal obligation of the Hilperts to pay the indebtedness which was merely a lien against the real property. The contrary holding in this case constitutes direct conflict with the *Hilpert* case, not acknowledged by the Court below because of its erroneous analysis of the *Hilpert* case.

The Tax Court (21 TC at p. 1060) attempted to distinguish the *Hilpert* case on the ground that there were certain circumstances there, not present in this case, which "influenced the Fifth Circuit considerably in reversing our decision in that case"—that Hilpert had treated the original transfer of the property to his mortgagee as a sale and had paid a tax thereon, and that he had also sold the property after having successfully contended in Court that the original transfer was a mortgage and not a sale, and he had paid another tax on that transaction.

It seems quite obvious that the manner of reporting the original transaction could not have been determinative of the taxable effect of the final accounting

in the *Hilpert* litigation. However, if the facts of that case did create a distinction because of the hardships a different result might have been produced for the Hilperts. They certainly created no greater equity than here where the effect of the decision of the Court below crowns petitioner's nine years of litigation to recover his property with confiscation of rentals he never received by pyramiding them in the high surtax year of 1947, and by depriving him of the benefit of his accumulated depreciation for the same period, which could only be taken annually.

CONCLUSION.

The direct conflict between the United States Court of Appeals for the Fifth and Ninth Circuits on an important principle of law involved in the administration of the income tax statutes should be resolved by this Court. It is respectfully submitted that this petition for a writ of certiorari should be granted.

Dated, Castro Valley, California,
August 7, 1956.

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WILLIAM F. HANNON,
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(Appendices A, B and C Follow.)